New Jersey Law Journal

VOL. CXCI– NO.6 – INDEX 385 FEBRUARY 11, 2008 ESTABLISHED 1878

Estate Planning

Guiding Wealth Through the Generations

Multigenerational transfer mechanisms allow grantor to direct distribution of assets

By Steven D. Leipzig and Lori I. Wolf

Our federal tax system and that of many states, including New Jersey and New York, impose significant taxes on the transfer of wealth from one generation to the next. While it is certainly advantageous to reduce the imposition of estate taxes on a client's assets passed down to his children, even more dramatic tax savings can be achieved by structuring estate plans to allow assets to pass to grandchildren and even younger generations, without the imposition of a tax on generation-skipping transfers (GST Tax). As estate planners, we employ a variety of strategies that achieve this objective and significantly enhance the amount of wealth that will be available to younger generations on an after-tax basis.

The federal transfer tax system imposes the GST tax to prevent taxpayers from "skipping" a generation and avoiding a tax at each generational level.

Leipzig and Wolf are members of the tax, trusts and estates department of Cole, Schotz, Meisel, Forman & Leonard of Hackensack.

The GST tax is set forth in Chapter 13 of the Internal Revenue Code and is imposed at the highest marginal estate tax rate. The GST tax is imposed on (i) direct skips, defined as direct transfers, during life or at death, to skip persons (individuals or trust for the benefit of individuals two or more generations below that of the transferor); (ii) taxable distributions, which are distributions out of trusts to skip persons; and (iii) taxable terminations, which are defined as trust termination events as a result of which assets pass to skip persons.

The Code provides transferors with an exemption from the GST Tax, which under current law is $2 million, and is scheduled to increase to $3.5 million in 2009. Although the law is likely to change before 2010, current tax legislation provides for a one-year repeal of the GST tax in 2010, followed by a reversion to prior law in 2011. Under prior legislation, the GST exemption is an inflation adjusted amount ($1,120,000 in 2003, with an inflation adjustment thereafter).

For clients seeking to maximize the wealth passing to grandchildren and younger generations, making sure that they are taking full advantage of the GST exemption constitutes the first planning objective. This objective can be achieved through an appropriate testamentary dispositive scheme. This can involve a true "skip" of the children's generation by direct transfers of the GST exempt amounts to grandchildren or trusts for their benefit. This approach, however, deprives the children of access to the assets. Therefore, a popular alternative is to create trusts for the benefit of each child for his or her lifetime and then on to younger generations. This structure allows the GST tax advantages to be achieved while still enabling the children of the transferor to benefit from the assets if necessary.

Such lifetime trusts typically provide for discretionary distributions to the child and his or her issue during the child's lifetime. Depending on the non-tax objectives to be achieved by the trust, many of which are described later in this article, the child can be trustee of his or her trust if appropriate. In order to avoid inclusion of the trust assets in the child's estate, however, a child's ability to make distributions to himself or herself and to children to whom he or she owes a legal obligation of support must be appropriately limited.

From a tax perspective, the goal of GST-exempt multigenerational trusts is to allow the income earned by the trust to accumulate, or be distributed to skip persons, so that the maximum amount can pass on a GST tax-free basis. Accordingly, the children should utilize other assets during their lifetimes and allow the GST-exempt trusts to grow to the maximum extent possible. The power of assets growing on a tax-free basis is extremely powerful. If one assumes that children will survive their parents by 35 years and that trusts funded with $4 million will grow through income accumulation and capital appreciation at the rate of 6 percent per year, over $30 million will be available to pass to grandchildren on a transfer tax-free basis.

If a client desires to shelter additional assets from the GST Tax, there are many powerful strategies that can achieve significant leveraging of the GST exemption so that even greater amounts of wealth can pass on a tax-free basis to younger generations. One of the more traditional leveraging strategies involves irrevocable life insurance trusts, which contain dynasty trusts for several generations.

Life insurance is typically acquired by wealthy clients to provide liquidity to a surviving spouse if necessary and to help fund the estate tax liability at the surviving spouse's death. Insurance is very important for clients that own significant business or real estate assets without the necessary liquidity to pay estate taxes. As a general matter, the leveraging in the life insurance context is achieved through the allocation of the clients' GST exemptions to the premium payments, rather than to the death benefit, as reflected below.

If a married couple decides that $10 million is needed to pay estate taxes, they would set up an irrevocable trust to be the owner and beneficiary of a $10 million policy with an annual premium of $200,000. Following the second death, the trust would be held for the lifetime benefit of the children and then pass to grandchildren and even younger generations. Although the insurance proceeds are earmarked for taxes, they are typically used to purchase assets from the estate, so that there is a swap of the estate's assets for the insurance proceeds. This leaves the trust with value equivalent to the amount of insurance proceeds ($10 million in this example) that would pass under the trust for the benefit of multiple generations. On an annual basis, the couple would transfer $200,000 into the trust and allocate $200,000 of their GST exemptions to each premium payment. If we assume premium payments are made for 15 years, they would have used $3 million of their GST exemptions but would end up with $10 million passing free of both federal and state estate taxes and GST taxes.

Further GST planning can also be accomplished through other strategies. Techniques that involve the use of valuation discounts and/or property that has significant appreciation potential can achieve significant leveraging of the GST exemption. This can be accomplished through sophisticated gifting strategies or through a variety of techniques that involve sales of assets by transferors to GST exempt dynasty trusts.

There are many nontax reasons why clients may choose to create lifetime trusts for the benefit of multiple generations. The primary motivators are: (i) building a family legacy for future generations; and (ii) asset protection. These factors and others are described further below.

A dynasty trust for the benefit of multiple generations can be used to enhance the family legacy. By leaving assets in lifetime trusts for children, rather than outright distributions, clients can maximize the likelihood that their assets will remain in the bloodline and do not pass to a child's spouse at the child's death. Equal trusts could be established for children to ensure that while the children may have different financial needs at different times in their lives, each child has an equal share of the assets initially allocated to a trust for his or her benefit. Under the equal trusts, during the children's lifetimes, the trustee can make discretionary distributions of the income and principal from the trust to the child for whom the trust was created (and to that child's children) for health, education, maintenance and support purposes. At a child's death, the assets could pass under the terms of the trust to the deceased child's issue (children and grandchildren). To maximize flexibility, each child could be given a limited power of appointment, allowing him or her to direct how the assets should pass to his or her descendants.

If, instead, assets are given to a child on an outright basis, these assets will pass according to the child's will at death. In most cases, where a child is married, this means that the assets will pass to the child's spouse (instead of staying in the client's bloodline and passing to the deceased child's children). The spouse could remarry, leaving these assets to his or her future spouse and/or children from the subsequent marriage, or the spouse could consume or squander the assets, thereby reducing the assets ultimately passing to grandchildren.

By utilizing a dynasty trust, distributions could be made to family members for multiple generations for college, housing expenses, medical expenses, the cost of purchasing a home and other meaningful expenses. The lifetime trust could limit the use of trust assets for certain purposes (such as education costs) or could give the trustees broad discretion in how to use the assets.

A trust can be an effective way to protect children. For a child with special needs, a lifetime trust is imperative to ensure that governmental benefits (such as Medicaid) remain available to the child.

If a client lacks confidence in a child's financial experience and good judgment necessary to appropriately invest the assets, a lifetime trust can be used to permit one or more individuals designated as trustee by the client to control the monies, alone or together with the child for whom the trust was created.

Similarly, a trust can be appropriate for children who have poor spending habits. An independent trustee can be used to limit the child's access to trust assets. It is important for a client to name as trustee someone with similar values and who can refuse or approve a child's request for funds as appropriate under the circumstances. By placing controls on the assets, the trustee can maximize the likelihood that the assets will remain available for the child's lifetime (instead of being depleted). The child can serve as a trustee together with one or more others designated by the clients. The co-trustee(s) can assist the child with investment decisions and can assist in making decisions regarding the timing of distributions from the trust to the child.

A lifetime trust can protect a child from others. Through the trust mechanism with an independent trustee, a naïve child cannot be taken advantage of by someone who might learn that the child has access to money. Further, assets that remain in trust for the benefit of a child generally are protected from the claims of creditors, including, but not limited to, a spouse in the event of a divorce. In many jurisdictions (including New York and New Jersey), assets received by gift or inheritance are protected from the claims of a spouse on divorce even if the assets are owned outright by the child. The child could, however, move to a jurisdiction which does not afford that protection for gifted and inherited assets. Additionally, a child can place the assets in a joint account or joint investment, thereby losing the asset protection that would have been available if the assets were segregated. By using a lifetime trust for the child, the client protects the assets for the child's benefit, and better insures that the trust assets will not be allocated to a child's spouse upon divorce. Thus, the trust structure becomes important both (i) to protect assets from a child and his or her creditors, spending habits and poor financial judgment and (ii) to protect the assets so they remain available to a child, notwithstanding the child's creditor issues, spending habits or financial inexperience.

The lifetime trust structure can be used to encourage children to maintain a certain lifestyle, as well as to discourage negative behavior. Certain criteria, such as completion of educational levels, can be set forth as incentives, with either cash rewards for satisfying the criteria or a general directive to the trustees that specific objectives are important and should be rewarded with additional distributions. Alternatively, trustees can be directed to withhold distributions to a child if the child does not meet certain value standards, which could tie into certain personal habits, such as refraining from gambling or substance abuse, or could involve general goals, such as becoming productive members of society.

In general, dynasty trusts can also be used to reduce state income taxes on trust assets over multiple generations. If a trust accumulates income or incurs a large capital gain, state income taxes can be a significant concern. Generally, states tax resident trusts on their worldwide income, and tax nonresident trusts only on income generated on property within the state. While the definition of "resident trust" varies from state to state, most definitions fall into two main categories: (1) a majority of states define "resident trust" as a trust created by in-state residents, and (2) a minority of states define "resident trust" as a trust whose beneficiaries or trustees are residents of the state, or a trust that is administered in the state.

Despite the provisions set forth in the law described above, several courts (including N.Y. and N.J. courts) have held that it is unconstitutional to tax a trust's income if the only contact with the state is the residence of the grantor. In those states, a change of trust situs may be considered, especially to states that either do not have an income tax (i.e., Florida) or do not tax the income of a trust if there are no in-state beneficiaries (i.e., Delaware). A change of situs may be accomplished through changes in the trustee (i.e., the appointment of a Delaware corporate trustee), operator of a state decanting statute (i.e., N.Y. EPTL Section 10-6.6(b)) or a court proceeding.

Consideration must be given to the rules of the trust's current situs and desired situs, taking into account the location of the grantor, trustees, beneficiaries and assets of the trust; but dynasty trusts provide the potential for substantial state income tax savings.

No matter what the motivation is for the creation of a dynasty trust, it is critical for the client to consider the appropriate trustees and successor trustees when creating the trust. Clients should be encouraged to identify trustworthy individuals with financial savvy as trustees. In some cases, it may be appropriate for the child to serve as sole trustee of the trust for his or her benefit (such as where the trust is being used to provide a family legacy and to obtain GST planning). In other cases (such as where a child lacks financial experience or has poor spending habits), it is appropriate to have someone other than a child as the trustee (though the child can serve with the other trustee(s)). Where a trust is going to last for more than one generation, a client should consider naming a financial institution either initially as trustee or as a successor trustee once all of the individuals named are unable to serve. Trust beneficiaries could have the ability to remove the financial institution and replace it with another financial institution to provide protection in the event that the financial institution serving as trustee is not managing the assets appropriately, is taking excessive commissions or is not being responsive to the needs of the beneficiaries.

In conclusion, there are numerous reasons why clients should consider the use of a dynasty trust. From a tax perspective, multiple generation trusts will allow assets to grow for generations, unreduced by wealth transfer taxes. From a nontax perspective, there are a myriad of important reasons why lifetime trusts become an attractive option to provide protection and to preserve trust assets for children, grandchildren and beyond. ■